IRAQ

Iraq has faced the ISIS war and a protracted reduction in oil prices since mid-2014. Strong oil production sustained growth, but the non-oil economy has contracted sharply. Ten percent of Iraqis remain displaced due to continuous unrest. A large international financing package supports the government's reform effort. Following an OPEC agreement, oil production would decrease in 2017, but higher oil prices would improve fiscal and external balances. Non-oil activity would return to positive growth. Risks remain high.

Recent developments

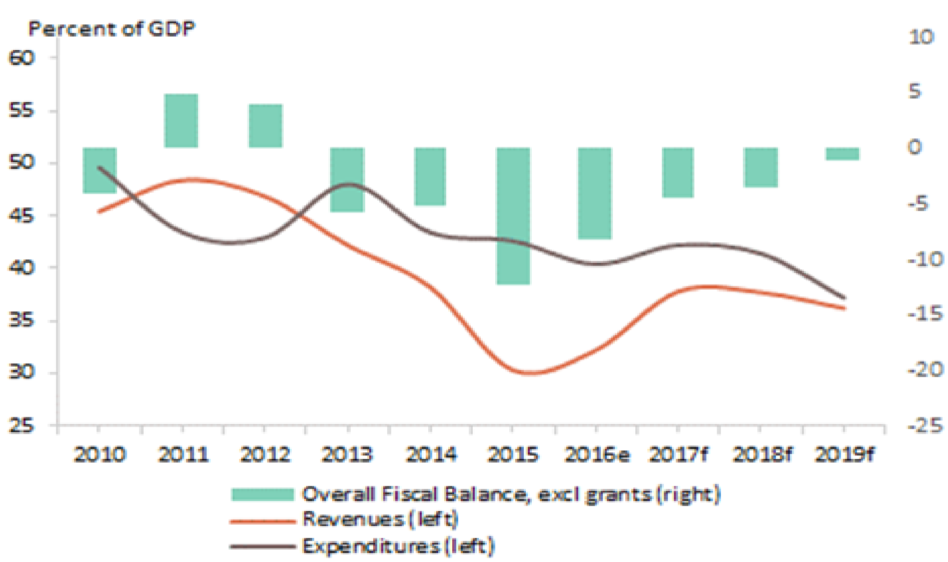
The ISIS insurgency and the protracted reduction in oil prices since mid-2014 have severely impacted Iraq's heavily oil-dependent and non-diversified economy. The economy sharply decelerated in 2014, before recovering in both 2015 and 2016. GDP grew at 4.8 percent in 2015 on the back of a 19.4 percent increase in oil production, following a slowdown to 0.7 percent in 2014. In 2016, overall growth is estimated to have reached 10 percent thanks to strong oil production. The security and oil shocks forced the government to rapidly reduce expenditure which negatively affected private sector consumption and investment. The non-oil economy contracted by 10 percent a year in 2015 and 2016. Inflation averaged 0.4 percent in 2016.

Lower oil receipts and higher humanitarian and security-related expenditure worsened the fiscal and external balances. The fiscal deficit reached 12.3 and 8.2 percent of GDP in 2015 and 2016, respectively, despite rapid fiscal consolidation. The fiscal deficits have been mainly financed through domestic bank financing. Domestic and external arrears also accumulated to US$11 billion. The current account balance turned into a deficit of 6.5 percent of GDP in 2015, reflecting a 41 percent drop in oil export revenues, and has further worsened to 7.2 percent of GDP in 2016. To partly finance this deficit, total international reserves have declined from about US$54 billion by end-2015 to US$47 billion at end-2016.

A large international financing package supports the government's efforts to implement reforms to control expenditure and lay the ground for structural reforms. In 2016, the World Bank provided US$1.44 billion (Including US$443.8 million guaranteed by the UK and Canada) Development Policy Financing (DPF) loans and the IMF provided US$1.2 billion financing as part of a three-year program supported by a Stand-By Agreement. In January 2017, the government issued a US$1 billion bond guaranteed by the U.S. government. JICA, and France are expected to provide additional budget support. In addition to measures to increase non-oil revenue, control the wage bill and non-contributory pension expenditure, the government has started piloting a new electronic salary payment system. It has sent to Parliament a new Social Insurance Law to improve the financial sustainability of the public pension fund, and adopted and operationalized a new proxy-means testing system to better target cash-based social transfers to the poor. It committed to reduce gas flaring associated with oil extraction and increased gas capturing. In January 2016, the government increased four-fold the electricity tariffs to reduce subsidies and later adopted a strategy to increase tariff collection. Long-standing structural vulnerabilities have been exacerbated by the ongoing violence and economic disruption. The security crisis is estimated to have created more than 3.4 million internally displaced persons.

Iraq has one of the lowest employment-to-

FIGURE 1 **Iraq** / Fiscal Accounts (percent of GDP)



Sources: Ministry of Finance; IMF; and World Bank staff projections population ratios in the region, even among men, and the 2014 crisis has led to an estimated reduction in employment by 800,000 jobs. The Public Distribution System provides the only safety net for the vast majority of the poor, and is currently stretched to its limits.

Outlook

Iraq's economic outlook is expected to improve under the assumption of a more favorable security environment, and continued fiscal consolidation. The non-oil economy after three years of contraction is expected to rebound in 2017 due to improved security and higher non-oil investment spending. However, real GDP is expected to contract by 3 percent in 2017 due to a projected 6 percent reduction of oil production, as a result of the agreement to reduce oil production by 1.2 million barrels per day reached among OPEC members in November 2016. Lower production is expected to reduce oil export volume by 5 percent in 2017. Oil production and exports are projected to return to their 2016 level in 2018 and 2019. Iraq's oil export prices are projected to average US$47.4 per barrel in 2017, compared to an average of US$35.6 in 2016. Higher oil prices would reduce the overall fiscal and current account deficits to 4.4 percent of GDP and 4.5 percent of GDP in 2017. The public debt is expected to remain sustainable over the medium term, given the projected fiscal consolidation and improved growth prospects. The 2017 budget re-instated the budget sharing agreement by which the Federal Government transfers 17 percent of budget expenditure, equivalent to ID11.6 trillion (US$9.8 billion) to KRG in exchange for KRG delivering 550,000 bpd to SOMO, the national oil company. While evidence of resumption of the transfers is not yet available, both parties have included the federal transfers in their 2017 budgets.

Risks and challenges

Weaker than projected global growth or higher than-expected supply of oil into the global markets could put downward pressure on oil prices and renew pressures on Iraq's twin deficits. The external debt remains highly vulnerable to a current account shock, such as a further reduction in oil prices or a real exchange rate depreciation. Refinancing risks due to large gross financing needs are partly mitigated since about one third of domestic debt consists of short-term debt held by the central bank. Any worsening of the ISIS insurgency and political tensions would materially and negatively impact Iraq's economy, require higher security expenditure and undermine the reform effort. Risks are also related to the capacity of the government to provide public services and start reconstruction. Tensions could also be related to the revenue sharing agreement between Baghdad and Erbil. As in the past, its implementation could be undermined by spending pressures in Baghdad and changes in oil prices.

TABLE 1 **Iraq** / Macro outlook indicators (annual percent change unless indicated otherwise)

	2014	2015	2016 f	2017 f	2018 f	2019 f
Real GDP growth, at constant market prices	0.7	4.8	10.1	-3.1	2.6	1.1
Private Consumption	7.6	20.0	16.4	-6.0	3.1	3.7
Government Consumption	-13.2	29.1	31.0	-13.0	-4.3	-4.4
Gross Fixed Capital Investment	22.3	-2.1	-13.0	2.0	-2.7	-0.8
Exports, Goods and Services	-4.7	49.1	13.6	-4.9	4.6	0.1
Imports, Goods and Services	-7.2	11.2	-0.1	4.9	-4.0	-3.6
Real GDP growth, at constant factor prices	0.7	4.8	10.1	-3.1	2.6	1.1
Agriculture	-2.0	-49.3	59.6	0.0	7.0	7.0
Industry	2.1	5.1	8.0	-2.5	2.0	0.6
Services	-1.7	10.5	11.3	-4.5	3.3	1.6
Inflation (Consumer Price Index)	2.2	1.4	0.4	2.0	2.0	2.0
Current Account Balance (% of GDP)	2.6	-6.5	-7.2	-4.5	-4.7	-2.5
Fiscal Balance (% of GDP)	-5.3	-12.3	-8.2	-4.4	-3.6	-1.0
Debt (% of GDP)	31.8	55.0	63.1	59.8	60.0	58.5
Primary Balance (% of GDP)	-5.0	-11.7	-7.0	-3.1	-2.5	0.1

Sources: World Bank. Macroeconomics and Fiscal Management Global Practice.
Note: f = forecast.